Supreme Court, U.S.
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No.

In The

Supreme Court of the United States

October Term, 1996

MIDWEST INVESTMENTS, et al.
Petitioner,

vs.

SECURITIES AND EXCHANGE COMMISSION,
Respondent

Petition for Writ of Certiorari to the United States Court of Appeals for the Sixth Circuit

PETITION FOR WRIT OF CERTIORARI

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QUESTIONS PRESENTED FOR REVIEW:

I. Neither the postal clause nor the commerce clause of the U.S. Constitution authorizes this particular scope and manner of federal regulation of the sale of intrastate securities.

II. The District Court's broad application of joint and several liability in its disgorgement order of $791,625 against each defendant is disproportionate to the amount of the alleged illicit gains as found in the record, amounts to an excessive penalty or fine, and/or violates the petitioner's rights guaranteed under the V, VI, VIII and XIV amendments of the united states constitution.

III. The SEC's approach, and the practical impact of civil enforcement actions, amounts to a criminal investigation under the guise of a civil enforcement action which enables the sec and other government agencies to gather information which may be utilized in subsequent criminal indictments and amounts to entrapment in violation of the petitioner's constitutional rights as guaranteed by the I, V and XIV Amendments of the United States Constitution.

List Of Parties:

The parties to the proceedings in the United States Court of Appeals were the Securities and Exchange Commission, Midwest Investment, Inc., Robert D. Hodge, Michael J. Eberle, Thomas J. VanEcho, Thomas L. Costello, Donald H. Gilliland and Thomas J. Williamson

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Petition For Writ of Certiorari

Petitioners, Midwest Investment, Inc., Robert D. Hodge, Michael J. Eberle, Thomas J. VanEcho, Thomas L. Costello, Donald H. Gilliland and Thomas J. Williamson, respectfully prays that a writ of certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Sixth Circuit.

Unreported Opinion

The opinion of the United States Court of Appeals for the Sixth Circuit is unreported as *SEC v. Midwest Investments, et al.*, but is reprinted in its entirety in Appendix B.

Statement of Jurisdiction

Petitioner respectfully requests this Honorable Court to review the opinion of the United States Court of Appeals for the Sixth Circuit decided on May 6, 1996, pursuant to the jurisdiction vested therein by 28 U.S.C. Sec. 1254(1). A timely petition for rehearing was filed to the United States Court of Appeals for the Sixth Circuit, on June 20, 1996 and was denied on July 16, 1996.

Petitioner urges this Court to grant this extraordinary appeal for discretionary review in this case even though some of the primary issues in this request were raised for the first time within the aforementioned petition for rehearing. This Court has granted discretionary review to issues raised for the first time within a petition for rehearing when the federal and constitutional policy implications were so serious, that this esteemed tri-

bunal entertained consideration of the issues raised within the petition for rehearing. *Hathorn v. Lovorn* 457 U.S. 255, 102 S. Ct. 2421, 72 L.Ed.2d 824 (1982).

The strong pattern of subsequent criminal indictments and prosecution of citizens of the United States investigated under the auspices of a civil tribunal, and the broad application of disgorgement necessitate that the Court consider this case by the gravity of the federal, constitutional, and policy bases that were raised in Appellant's appeal and petition for rehearing.

CONSTITUTIONAL PROVISIONS AND RULES INVOLVED

(i) U.S. Const. Am I

> Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof; or abridging the freedom of speech, or of the press; or the right of the people to peaceably to assemble, and to petition the Government for a redress of grievances.

(ii) U.S. Const. Am V

> No person shall be held to answer for a capital, or otherwise infamous crime, unless on a presentment or indictment of a Grand Jury, except in cases arising in the land or naval forces, or in the Militia, when in actual service in time of War or public danger; nor shall any person be subject for the same offense to be twice put in jeopardy of life or limb; nor shall be compelled in any criminal case to be a witness against himself, nor be deprived of life, liberty, or property, without due process of law; nor shall private property be taken for public use, without just compensation.

(iii) U.S. Const. Am. VIII

> Excessive bail shall not be required, nor excessive fines imposed,

nor cruel and unusual punishments inflicted.

(iv) U.S Const. Am. X

The powers not delegated to the United States by the Constitution , nor prohibited by it to the States, are reserved to the States respectively, or to the people.

(v) U.S. Const. Am. XIV § 1

Section 1. All persons born or naturalized in the United States, and subject to the jurisdiction thereof, are citizens of the United States and of the State wherein they reside. No State shall make or enforce any law which shall abridge the privileges or immunities of citizens of the United States; nor shall any State deprive any person of life, liberty, or property, without due process of law; nor deny to any person within its jurisdiction the equal protection of the laws.

STATEMENT OF THE CASE

On April 12, 1993, plaintiff SEC filed an action in the district court seeking a temporary restraining order, a preliminary and permanent injunction, and other equitable relief against defendants, alleging that they had violated the Securities Act of 1933, 15 U.S.C. §§77a et seq., and the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a et seq. through knowing and active participation in the sale of shares of intrastate stock at artificially inflated and manipulated prices including undisclosed excessive markups. A temporary restraining order was granted.

On May 3 and 4, 1993, the district court conducted hearings on the request for a preliminary injunction. On May 18, 1993, the district court issued an order granting the preliminary injunction, and, in the same

order, made extensive findings of fact and conclusions of law in support of the preliminary injunction

Defendants sought to appeal the district court's grant of the preliminary injunction, filing a notice of appeal on August 13, 1993. On November 18, 1993, the appeal was dismissed for lack of jurisdiction, finding that it was unripe because no final appealable judgment had been issued by the district court.

On October 13, 1993, the plaintiff SEC filed a motion seeking summary judgment on October 13, 1993, to which defendants responded on November 15, 1993. Thereafter, on March 31, 1994, the district court granted summary judgment for the SEC. In its order, the district court made permanent its preliminary injunction, held defendants jointly and severally liable for the disgorgement of $791,625, ordered defendants Hodge and Eberle to pay civil penalties in the amount of $25,000 each; and ordered the defendants VanEcho, Costello, Gilliland and Williamson to pay civil penalties of $10,000 each.

On April 14. 1994, defendants filed a timely notice of appeal. However, on that same date, the SEC filed several time-tolling motions under Fed. R Civ. P. 59(e).

On February 21, 1995, the parties submitted a stipulated proposed final judgment and order of permanent injunction and other equitable relief to the magistrate judge. On March 16, 1995, the district court

adopted the magistrate judge's report and recommendation of February 2, 1995, and signed the parties' stipulated proposed final judgment and order of permanent injunction and other equitable relief.

Pursuant to Fed. R. App.P. 4(a)(4), the defendants otherwise timely notice of appeal, filed on April 14, 1994, was suspended during the pendency of the Fed. R. Civ. P. 59 time tolling motions, and it became effective when the district court disposed of the time tolling motions in its final order of March 16, 1995.

Defendants appealed the district court's grant of summary judgment in favor of the SEC which granted a permanent injunction, disgorgement, and civil penalties against the defendants. The defendants argued that **(I)** *The Securities Act of 1933 and the Securities Exchange Act of 1934 were unconstitutionally applied to Appellees' offering and selling of securities wholly within the state of Ohio;* **(II)** *The district Court erred in granting judgment for appellee since it failed to find scienter as is necessary under section 17(a)(1) of the Securities Act, Sections 15(c) of the Exchange Act and all antifraud rules promulgated thereunder;* **(III)** *The district court erred in granting judgment for appellee since the evidence fails to manifest scienter as is necessary under section 17(a)(1) of the Securities Act, Sections 15(c) of the Exchange Act and all antifraud rules promulgated thereunder*, and finally **(IV)** *Disgorgement as imposed by the District Court is not a proper remedy for any negligent violation of*

sections 17(a)(2) and 17(a)(3) of the Securities Act. The jurisdictional basis for the appeal was 28 U.S.C. § 1291.

On May 6, 1996 the Court of Appeals for the Sixth Circuit rejected the defendants arguments and affirmed the judgment of the District Court. After the opinion of the Court of Appeals had been filed, the defendants filed a timely petition for rehearing on June 20, 1996. The defendants argued that **(I)** *District Court's order of joint and several liability of disgorgement is disproportionate to the amount of the alleged illicit gains as found in the record and/or amounts to a penalty or fine*; **(II)** *The finding of scienter is unsupported by the record*; and finally **(III)** *The SEC's approach, and the practical impact of disgorgement, amounts to a criminal investigation under the guise of a civil enforcement action which enables the SEC and other government agencies to gather information which may be utilized in subsequent criminal indictments and amounts to entrapment.* The court denied the defendant-appellants' petition for rehearing on July 16, 1996.

ARGUMENT

Petitioner respectfully requests that the Honorable Supreme Court of the United States of America grant this Petition for Writ of Certiorari for the foregoing reasons:

I. NEITHER THE POSTAL CLAUSE NOR THE COMMERCE CLAUSE OF THE U.S. CONSTITUTION AUTHORIZES THIS PARTICULAR SCOPE AND MANNER OF FEDERAL REGULATION OF THE SALE OF INTRASTATE SECURITIES.

At the appellate level, the SEC attempt to imply that the Supreme Court's statement in *Electric Bond & Share Co. v. SEC*, 303 U.S. 419, 442 (1938) that "Congress may not exercise its control over the mails to enforce a requirement which lies outside its constitutional province" does not encompass the interstate limitation of the Commerce Clause (SEC Br. at 25 n.20) and is erroneous. The interstate commerce limitation on Congress' power is explicitly based in the text of the Constitution. If Congress cannot use its control over the mails to enforce a particular requirement or otherwise police a particular activity on the grounds that the First Amendment prohibits such policing, a statement with which Appellees apparently agree (See *id*), it follows that Congress cannot use the mails to enforce a particular requirement or otherwise police a particular activity if such policing violates any other Constitutional right of the people or any Constitutional right of the States.

With respect to Appellees' Commerce Clause argument, Appellants contend that the court's holding in *Aquionics Acceptance Corp. v. Kollar*, 503 F.2d1225 (6th Cir. 1974) that the Commerce Clause authorizes Congress to regulate securities fraud even if the telephone is used solely to place intrastate calls effectively jettisons the principle of federalism embodied in the Tenth Amendment and elsewhere in the Constitution. Appellants contend that the courts which have held to the contrary reached the correct conclusion. As such, Appellants assert that the Commerce Clause issue addressed in *Aquionics* should be revisited by this Court.

In connection with the Commerce Clause issue, Appellants contend that the interstate and intrastate usage of the channels of interstate commerce in connection with the sale of securities is not so commingled as to necessitate the Congress' complete authority over the former requires that Congress exercise control over the latter. Moreover, intrastate telephone calls placed in connection with intrastate securities transactions do not substantially affect interstate commerce.[1]

Finally, to hold that the mere usage of the channels of interstate commerce in connection with the sale of intrastate securities authorizes Congressional regulation of the sale of intrastate securities is to unnecessarily authorize the federal policing of an otherwise local, i.e., state activity.

Appellants believe that there is ample justification to raise the sub-

[1]The determination of whether a particular activity "affect(s) interstate commerce sufficiently to come under constitutional power of Congress to regulate (it) is ultimately a judicial rather than a legislative question, and can be settled finally only by" the Supreme Court. United States v. Lopez, 63 U.S.L.W. 4343, 4345 n.2 (1995).

stantiative issue regarding the nature of telephone calls as primarily an instrumentality of intrastate commerce, as opposed to mail, because most telephone service is offered and controlled by state and local sovereignties? The SEC's use of telephone calls as a means automatically activate the Federal Security Statutes appears to be an affront to the Tenth Amendment rights of states and their citizens to conduct business activities within a specific state of legal residence. The business of consummating securities options contracts is inherently one the riskiest sides of the securities business in that the broker-dealer, as well as the investor, incurs considerable financial risk. By allowing the SEC to possess the broad sweeping power of invoking intrastate phone discussions as instruments of interstate commerce, there exists a substantial Federal threat to the vitality of business activities within individual states. The potential economic affect of such unfettered Federal power could be quite significant.

This Court should consider the fundamental unresolved constitutional issues in this aspect of securities regulation. Did Congress intend for the SEC to use intrastate telephone calls as a blanket means to invoke securities regulation? What constitutional limits should be placed on the SEC as it seeks in a somewhat slithery, serpentine manner, to probe and expand its perceived constitutional boundaries about actions that are deemed part of interstate commerce. The SEC would like this Court to believe that its' statutory mandate on this particular matter is

virtually open ended, and without constitutional scrutiny as to whether the scope and manner of the SEC's actions constitute the exercise of arbitrary federal power. There is the very real question as to whether the SEC's classification of intrastate phone calls as part of the instrumentalities of interstate commerce violates an individual's right to Fourth Amendment protections to unreasonable searches and seizures. Sometime in the future, under the SEC's reasoning regarding intrastate telephone calls, two persons having an intrastate conversation by any electronic means could be an included as instrumentalities of interstate commerce, and subject to regulation and subjugation by the SEC. Appellants ask this Court to put limits to the SEC's boa constrictor-like strangulation of the breath and life of basic individual rights and protections that are supposed to be guarded by the Constitution.

Another issue embedded within the classification of intrastate phone calls as instruments of interstate commerce by the SEC via the Commerce and Postal Clauses is the First Amendment rights of the Appellants to conduct targeted in-person solicitations of potential intrastate clients, who are financially sophisticated regarding security options transactions, via the telephone. This Court has upheld the basic constitutionality of such advertising as protected commercial speech in such cases as *Ibanez v. Florida Department of Business and Professional Regulation, Board of Accountancy* 512 U.S. 136, 114 S.Ct. 2084, 129 L.Ed.2d 118, 62 USLW 4503 (1994), and *Edenfield v. Fane*, 507 U.S. 761 , 113 S.Ct.

1792, 123, L.Ed.2d 543. The basic test for the protection of commercial speech from government regulation was established in *Central Hudson Gas & Electric Corp. v. Public Service Comm'n of N.Y*, 447 U.S. 557, 100 S.Ct. 2343, 65 L.Ed. 341. Government restrictions on commercial speech that is truthful and does not pertain to unlawful activity is permissible if the government (1) asserts a substantial interest in support of its' regulation, (2) establishes that the restriction directly and materially advances that interest; and (3) demonstrates that the regulation is "narrowly drawn" *id.*, at 564-565, 100 S.Ct. at 2350-2351.

In the present case, the SEC is attempting to regulate the legitimate advertising methods of the Appellants without meeting any of the principle elements of intermediate scrutiny established in the *Central Hudson* test. Appellants contend that the SEC could not meet any of these requirements concerning intrastate telephone calls which primarily concern intrastate securities transactions. First, because these telephone calls were primarily intrastate discussions concerning intrastate securities transactions, the SEC has no substantial interest in regulating these kinds of local business practices and standards. Second, the SEC has not advanced how policing local telephone traffic concerning local business issues directly and materially advances an interstate commerce interest of the federal government. To this date, the SEC has presented no data to support this conclusion. Third, the SEC has failed to narrowly draw or define what are the limits and restric-

tions being placed on Appellants' non-misleading and legitimate commercial speech activity that was conducted with investors.

Appellants assert that the SEC would like this Court to uphold and ratify this extra-constitutional attempt to regulate commercial speech and to circumvent the First Amendment. Unlike the state agency in *Florida Bar v. Went for It* , 115 S.Ct. 2371, the SEC has not conducted any substantiative research to back up its claim that interstate commerce is impaired or even affected by the appellants alleged illegal actions in the present case; yet the SEC asserts its authority over the appellants despite the lack of data on this issue. This Court should call the SEC's bluff on this issue, and require that this Federal agency follow the same specific requirements that other agencies must follow before the SEC intrudes on the private commercial speech practices that are well established standards the Appellants' local business community.

II. THE DISTRICT COURT'S BROAD APPLICATION OF JOINT AND SEVERAL LIABILITY IN ITS DISGORGEMENT ORDER OF $791,625 AGAINST EACH DEFENDANT IS DISPROPORTIONATE TO THE AMOUNT OF THE ALLEGED ILLICIT GAINS AS FOUND IN THE RECORD, AMOUNTS TO AN EXCESSIVE PENALTY OR FINE, AND/OR VIOLATES THE PETITIONER'S RIGHTS GUARANTEED UNDER THE V, VI, VIII and XIV AMENDMENTS OF THE UNITED STATES CONSTITUTION.

Prior to the Securities and Enforcement Remedies and Penny Stock Reform Act of 1990, the Securities and Exchange Commission had no

statutory authority to seek fines or require disgorgement of any ill-gotten gains resulting from excessive markups in administrative or civil proceedings. Before this Act, however, the Commission had sought disgorgement as an equitable remedy in numerous civil cases based upon the equity jurisdiction of the federal courts. This remedy is designed to prevent unjust enrichment by "divest[ing] wrongdoers of their illegal profits." *SEC v. Thomas James Assoc.*, Civ 90-319T, at 20 (W.D.N.Y. 1990); *see also SEC v. Commonwealth Chem. Sec., Inc.*, 574 F.2d 90, 102 (2d Cir. 1978) Since disgorgement primarily serves to prevent unjust enrichment, a court may exercise this equitable power only over property causally related to wrongdoing. *SEC v. First City Financial Corp.*, 281 890 F.2d 1215 (D.C. Cir. 1989). The amount to be disgorged is determined by reference to the rule that the remedy is remedial, not punitive, and that while a court may only order that the defendants restore, with interest the amount of their profit; a court may not assess an amount which would be construed to be a penalty or a fine. *SEC v. Washington County Utility Dist.*, 676 F.2d 218 (CA6 Tenn); *SEC v. Blatt,* 583 F.2d 1325 (CA5 Fla).

Disgorgement has taken its place as a remedy that is still being defined by the courts. However, it has often been referred to as a draconian remedy which is employed as a dangerous tactic. The concept of disgorgement has not been clearly defined, but has vaguely been interpreted through judicial construction. It is not even defined by Black's

Legal Dictionary. The court has attempted to employ disgorgement as a deterrent, however, the rule is so vague and unclear that neither the courts, the regulated community nor the government has a clear idea of what it means. In the interest of certainty, finality and time, it is important and essential that the regulated community have some clear idea of what the rules are for the imposition and application of disgorgement. In Justice Ginsburg's concurring opinion in *US v. First City National Corp.*, (1983) 555 F.Supp at 1233, she emphasized the key term of "calculus" in her analysis of injunctions. What this court must determine at this juncture is the proper "calculus" of disgorgement. Since disgorgement is a term of art based on case law as opposed to statute, the SEC is on a campaign to broadly apply this concept in its enforcement actions. However, it is imperative that this court set forth a clear rule so that in this case and future cases, plaintiffs and defendants can gage their actions accordingly. If a defendant does not know what is expected of them, then the idea, rule or concept of disgorgement is illusory in as much as the rule itself does not state clearly, or perhaps at all, the conduct or behavior that is in fact to be deterred. It is not sufficient to merely say that disgorgement is a proper remedy for securities violations without setting forth specific standards with respect to its application.

While the Commission has enjoyed a broad application of seeking the remedy of disgorgement in a variety of securities fraud actions, disgorgement of excessive markups has only recently been the subject of litigation

in federal court. In 1990, the Commission, in *SEC v. Thomas James Associates*, Civ. 90-319T (W.D.N.Y. 1990), sought illegal profits from excessive markups in addition to injunctive relief against a brokerage firm and two of its principals. While the court held that disgorgement was appropriate in *Thomas James Associates*, it did not rely on the Commission's markup computation of $4.5 million in calculating the amount to be disgorged. Instead, the court found the appropriate amount of disgorgement to be the $3 million in gross revenues offset by 50% to account for certain business expenses, including brokers commissions, telephone charges, underwriting expenses, and a proportionate share of overhead.

The illusory concept of disgorgement raises many difficult questions which the courts are and will be struggling to answer. For instance, what is the measure of recovery where value has increased or decreased? What expenses, if any, should the court allow the defendant who committed the fraud as a setoff against his total profits? Does the concept of joint and several liability apply?

What this court must address in the case *sub judice* is the question of the applicability of joint and several liability to a multiplicity of defendants for profits from excessive markups. To date, disgorgement has been applied to a limited number of defendants of relatively equal levels of authority. *SEC v. Patel,* 61 F.3d 137 (2d. Cir. 1995) (where sole individual punished was founder, director and vice president); *SEC v. Thomas James Associates,* Civ. 90-319T (W.D.N.Y. 1990) (where

corporation and two principals disgorged); *SEC v. Bilzerian*, 29 F.3d 689 (D.C. Cir. 1994) (where only investor was disgorged for violations and the broker was excused); *SEC v. Blavin*, 760 F.2d 706 (6th Cir. 1985) (where investor was disgorged for violations); *SEC v. Blatt*, 583 F.2d 1325 (5th Cir. 1978) (where law firm partners were disgorged, but others who participated were excused from disgorgement); *SEC v. Commonwealth Securities Inc.*, 574 F.2d 90 (where the court examined the limited participation of two defendants in the fraudulent scheme). In **all** cases involving disgorgement and a multiplicity of defendants, the courts have made inquiries as to the extent of each defendants' involvement and culpability. This court has failed to do so. In the case *sub judice*, there are a multiplicity of defendants whose positions varied from President of the company to managers to salesmen. What the District Court, at the urging of the SEC, has attempted to do is apply joint and several disgorgement to all of the defendants regardless of the extent of their involvement in the alleged violation. In effect, this is a penalty which reaches beyond the proceeds of each individuals conduct. The court in *SEC v. World Gambling* specifically stated:

> While disgorgement functions primarily to prevent a party's unjust enrichment and thereby to deter improper conduct, joint liability serves primarily to make whole the injured party, and in the process to punish if necessary any one legally responsible. ***To the extent that joint liability requires payment of a sum greater than the profits unlawfully gained by the fraudulent transactions, it is a penalty and is therefore improper.*** *See SEC v. Blatt*, 583 F.2d 1325, 1335 (5th Cir. 1978); *SEC v.*

Manor Nursing Centers, 458 F.2d 1082, 1104 (2d Cir. 1972).

The court went on to state that had the defendant: "obtained only a certain amount from the scheme, then he could conceivably have argued convincingly that, despite his extensive participation in the conspiracy, ***he should not be required to disgorge what he did not receive***." *SEC v. World Gambling Corp.*, 555 F.Supp at 931. (Emphasis added). In the case sub judice, there is no factual basis for a blanket disgorgement where the record shows that disgorgement was imposed as an afterthought by the court. The record clearly and unequivocally shows that the court made no significant inquiry as to the varying degrees of responsibilities and duties of the defendants. Since no evidence has been heard as to each defendant's responsibility, there exists a disputed issue of material fact for which the court cannot grant summary judgment and hold each individual liable for $791,625.

In the case *sub judice*, the court has erroneously relied upon a figure of $791,625, to which a certified public accountant and a branch chief in the Division of Enforcement of the Securities and Exchange Commission, George Miller admits in his own testimony was inaccurately based on data he was instructed to use. (Tr119-122) The transcript clearly and unequivocally shows that Mr. Miller erroneously based his calculation on the incorrect assumption that the cost to Midwest was $1.25, when in fact the record clearly shows that the cost was varied. As such, the disgorgement figure of $791,625 does not reasonably approxi-

mate the amount of unjust enrichment and fails to establish a causal connection between the alleged illicit gains and the individual defendant-appellants. *SEC v. First City Financial Corp.*, 281 890 F.2d 1215. In the Plaintiff-Appellant's opening statement, counsel clearly states that in over 400 transactions there was a mark-up of over 152% and that in over 300 transactions the markup charged by Midwest exceeded 12%. (Tr 13). In the case *sub judice*, inspite of the fact that disgorgement is a remedy having to do with unjust enrichment, the SEC did not have to perform an audit, made no real inquiry into the amount received and utilized numbers based on speculation and conjecture. The SEC may assert that it is only required to prove an amount of disgorgement reasonably approximate of the benefits or profits causally connected to the violation, however they never attempted to show the extent to which each defendant was unjustly enriched. *First City Financial Corp.*, 890 F.2d at 1231. Further, the record clearly shows that the plaintiff SEC never claimed it would be impossible to calculate the amount that each defendant was unjustly enriched. In the recent case of *SEC v. Hughes Capital Corp.* 917 F.Supp 1080 (D.N.J. 1996), the court held that negligent participants in fraudulent scheme would not be held jointly and severally liable for profits of fraudulent offering which could not be traced to individual defendants. In essence the court has affirmed a disgorgement where it has made no real inquiry into control, alter ego, but has relied upon conclusory statements of the SEC without any supported facts.

In the Supreme Court's decision in *United States v. Halper*, 490 U.S. 435, 109 S.Ct. 1892 (1989), states that it is improper "where a fixed penalty provision subjects a prolific but small-gauged offender to a sanction overwhelmingly disproportionate to the damages he has caused." In the case *sub judice*, the disgorgement order asks each of the defendants to give up an amount clearly in excess of the amounts of their alleged illicit gains. The record states that the defendants Eberle, Hodge, Costello, Gilliland, VanEcho and Williamson personally received $50,000, $52,600, $20,031, $32,664, $16,233 and $15,849, respectfully, in connection with Midwest's sale of Reitz Data Communication stock. As such, the joint and several liability on the disgorgement order of $791,625 ceased to be remedial in nature and constitutes punishment within the meaning of double jeopardy. *SEC v. Bilzerian* (DC Cir. 1994) 29 F.3d 689. The Supreme Court has clearly stated that while a court in equity may award monetary restitution as adjunct to injunctive relief, it may not enforce civil penalties. *Tull v. United States* (1987) 481 US 412, 107 S.Ct. 1831.

In a disgorgement order, the defendants may be liable for the disgorgement, but each respective defendant should not have to bear the entire amount of damages when several parties are partly at fault. To distribute liability equally without regard to the extent of each defendants alleged wrongdoing reduces the equity which the court attempts to enforce. The relief awarded a plaintiff in equity must be in accordance with equitable principles. *Rollin v. Grand Store Fixture Co.* 231 App. Div

47, 246 NYS 371. Equity looks at the whole situation and grants or withholds relief as good conscience dictates, and ***a court of equity is bound to look into all the facts and circumstances and determine what is fair, just and equitable***. *Jochum Bros. v. Ridgewood Pie Baking Co.* 210 App. Div. 428, 206 NYS 252 (Emphasis added). Equitable relief should be denied under certain circumstances where it would impose great hardship upon the defendant while at the same time resulting in little or no benefit to the plaintiff. *McClure v. Leaycraft*, 183 NY 36, 75 NE 961. In the case *sub judice*, the relief which was granted to plaintiff will be destructive of each defendant's means of personal support for themselves and their families. By imposing a punishment for which the individual defendants have no means of being able to satisfy and exceeding the amount of the alleged unjust enrichment, this court has placed the burden of the disgorgement over their heads for which there is no finality. The defendant-appellants ask that this court employ equitable principals in determining the propriety, function and clear application of disgorgement as a remedy in this case. In applying a "calculus of disgorgement," this court must consider the profits, expenses, the extent of responsibility of each defendant, and the amount each defendant was unjustly enriched. No evidence has been heard as to each defendants responsibility and to the extent to which each defendant was unjustly enriched. The court had made **no** attempt to examine the distinction between reckless fraud and negligent fraud as to each of the defendants. This distinction is important,

as negligent fraud is neither reckless nor intentional, and as such is important in apportioning specific liability of the disgorgement on the individual defendants. The courts' failure to examine the extent of each defendants actions, the plaintiff's failure to claim any impossibility to calculate the amount each defendant was unjustly enriched, the imposition of a disgorgement greater than an amount received, and the failure to provide the defendants any form of hearing on the amount of disgorgement, should put this court on notice that there clearly exists disputed issues of material fact for which this court cannot grant summary judgment and hold each individual defendant liable for $791,625. Equity and due process would require that this court remand this case to the lower court to determine the extent of each defendants varying degree of responsibility and the appropriateness of disgorgement as to each of the appellant-defendants.

III. THE SEC'S APPROACH, AND THE PRACTICAL IMPACT OF CIVIL ENFORCEMENT ACTIONS, AMOUNTS TO A CRIMINAL INVESTIGATION UNDER THE GUISE OF A CIVIL ENFORCEMENT ACTION WHICH ENABLES THE SEC AND OTHER GOVERNMENT AGENCIES TO GATHER INFORMATION WHICH MAY BE UTILIZED IN SUBSEQUENT CRIMINAL INDICTMENTS AND AMOUNTS TO ENTRAPMENT IN VIOLATION OF THE PETITIONER'S CONSTITUTIONAL RIGHTS AS GUARANTEED BY THE I, V AND XIV AMENDMENTS OF THE UNITED STATES CONSTITUTION.

The role of the SEC is to monitor the activities of the nation's securities markets in such a manner as to maintain the integrity of said markets

and protect investors from fraudulent activities and thus maintain investor confidence in the nation's capital markets. While this mission has historically been carried out by enforcement proceedings, generally seeking injunctive relief on the theory that such relief, properly and fairly applied, will deter future "bad conduct." More recently, the legislature added the "remedy" of disgorgement to the relief which the SEC had previously utilized as an "implied" remedy. Unfortunately, the ill-drafted legislation (Securities Act of 1933, §22(a), 15 U.S.C.A.§ 77, et seq.) provided no definition of "disgorgement" and allowed the Commission to promulgate rules with respect to exactly "what" disgorgement is and how it is to be applied.

While the SEC has stated that the sole purpose in the use of disgorgement is "deterrence", it is deterrence which goes beyond the traditional equitable concepts usually associated with injunctive or prohibition types of remedies. Deterrence has mostly been associated with criminal conduct and criminal or quasi-criminal laws and rules.

In its application of the disgorgement "remedy", the elements of the SEC civil enforcement complaints have consistently paralleled criminal causes of actions. In its initial civil enforcement proceedings, the SEC is consistently able to obtain information about the defendant(s) through discovery and the government's massive subpoena power. The civil enforcement proceedings amount to "quasi-criminal actions" with the ultimate goal to gather enough information to prosecute criminal indictments

against the defendants. The effect of this underlying purpose of the civil enforcement actions compromises the constitutional rights as criminal defendants because the defendant is never informed at the point of confrontation what these "matters" are really about. This clearly amounts to a criminal investigation parading under the guise of a "civil enforcement" action.

The SEC's unlimited "power to litigate" has the practical effect to deliberately destroy the defendant's economic ability to fight. Further, the impact of the disgorgement contributes to the destruction of the defendant's ability to fight. The practical effect of the disgorgement remedy is to assess a "judgment" which is nondischargeable in bankruptcy and additionally not reasonably collectible in most cases. Clearly, the almost total absence of any understandable or specific calculus in disgorgement cases makes the remedy punitive in nature and at least "quasi-criminal." By virtue of the SEC's unstated, but nevertheless active, focus of criminal prosecution, the defendants are immeshed in the entrapment of a "civil enforcement" action while in reality compromising their constitutional rights as criminal defendants.

The SEC's sole purpose in these disgorgement cases, is to punish and if possible to ultimately indict. It is common knowledge that the SEC shares the information it gleans from its "civil investigations" with law enforcement authorities for purposes of future presentation to grand juries. The SEC is authorized to transmit information evidence to the Justice

Department under 21(d)(1) of the Exchange Act. If "disgorgement" were used in the criminal context, there would be little argument about it being unconstitutionally vague. Yet there are a myriad of cases talking about deterrence and punishment (*See citations supra*) and the practical effect of the remedy is clearly punitive.

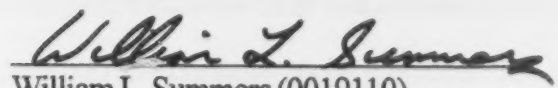
The strong pattern of subsequent criminal indictments and prosecution of individuals investigated under the auspices of a civil tribunal, and the broad application of disgorgement necessitate that the Court consider this case by the gravity of the federal, constitutional, and policy bases that are raised.

CONCLUSION

For the reasons set forth above, a Writ of Certiorari should issue to review the judgment and opinion of the Court of Appeals in this matter.

Dated: September 3, 1996.

Respectfully submitted,
SUMMERS, ANTHONY & VARGAS



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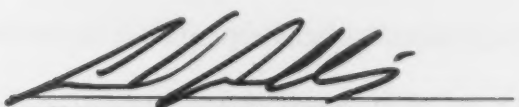

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SUMMERS, ANTHONY & VARGAS
Attorneys for Petitioners

- APPENDIX -

APPENDIX A- COURT OF APPEALS ORDER DENYING PETITION FOR REHEARING DATED JULY 16, 1996.

Case No: 94-3433

UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

SECURITIES AND EXCHANGE COMMISSION Plaintiff - Appellee v. **MIDWEST INVESTMENTS, INC.; ROBERT D. HODGE; MICHAEL J. EBERLE; THOMAS J. VAN ECHO; THOMAS J. COSTELLO; DONALD H. GILLILAND; THOMAS J. WILLIAMSON** Defendants' -Appellants	**ORDER**

BEFORE: MILBURN and BOGGS, Circuit Judges; and QUIST, District Judge*

Upon consideration of the petition for rehearing filed by the PARTY-TYPE,

It is **ORDERED** that the petition for rehearing be, and it hereby is, **DENIED**.

ENTERED BY ORDER OF THE COURT
/s/Leonard Green
Leonard Green, Clerk

* Honorable Gordon J. Quist, United States District Judge for the Western District of Michigan, sitting by designation.

APPENDIX B - COURT OF APPEALS FOR THE SIXTH CIRCUIT OPINION DATED MAY 6, 1996

No. 94-3433
UNITED STATES COURT OF APPEALS
FOR THE SIXTH CIRCUIT

SECURITIES AND EXCHANGE COMMISSION Plaintiff - Appellee v. **MIDWEST INVESTMENTS, INC.; ROBERT D. HODGE; MICHAEL J. EBERLE; THOMAS J. VAN ECHO; THOMAS J. COSTELLO; DONALD H. GILLILAND; THOMAS J. WILLIAMSON** Defendants' -Appellants	**ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF OHIO**

BEFORE: MILBURN and BOGGS, Circuit Judges; and QUIST, District Judge.* (FN *Honorable Gordon J. Quist, United States District Judge for the Western District of Michigan, sitting by designation.)

MILBURN, Circuit Judge. Defendants Midwest Investments, Inc., Robert D. Hodge, Michael J. Eberle, Thomas J. VanEcho, Thomas L. Costello, Donald H. Gilliland, and Thomas J. Williamson appeal the district court's grant of summary judgment in favor of plaintiff the Securities and Exchange Commission ("SEC"), which granted a permanent injunction, disgorgement, and civil penalties, resulting from defendants' violations of the Securities Act of 1933, 15 U.S.C. §§ 77a et seq.. and the Securities Exchange Act of 1934. 15 U.S.C. §§ 78a et seq. On appeal, the issues are (1) whether the securities acts were unconstitutionally applied to defendants since their selling of securities was done wholly intrastate, (2) whether the district court erred in granting summary judgment in favor of the SEC because the district court failed to find scienter, (3) whether the district court's finding of scienter is unsupported by the evidence, and (4) whether the district court erred in ordering disgorgement.

For the reasons that follow, we affirm.

I.

A.

The facts of his case are more fully set forth in the district court's order, particularly the preliminary injunction order dated May 18, 1993. Thus, we have only briefly summarized them here.

Defendant Midwest Securities, Inc., ("Midwest") is a broker-dealer, licensed by the State of Ohio to sell securities, with its principal place of business in Columbus, Ohio. Since 1993, Midwest has been owned by Midwest Management Company ("MMC"). Defendant Eberle was the president of Midwest. Defendants Hodge, Costello, Gilliland, Van Echo, and Williamson were employed at Midwest, and they were employed at Dublin Securities ("Dublin") before they were employed at Midwest.

Larry Reitz incorporated Reitz Data Communications, Inc., ("Reitz") on October 15, 1984. On or about September 1992, Reitz registered an initial public offering ("IPO") of 500,000 units of Reitz stock. Each unit sold for $1.00, and consisted of one share of Class A common stock and three warrants, each of which permitted the purchase of an additional share of class A common stock at a price of $1.00 per share.

Dublin arranged for the sale of the Reitz units. Many of the individuals purchasing the Reitz units were employees of Dublin and/or friends and relatives of Dublin employees. These individuals were called "insiders" by the Dublin employees. Defendants Hodge, Costello, Van Echo, Gilliland, purchased units of the Reitz. IPO.

Dublin began selling shares of Reitz to the public on October 20, 1992, and received orders from customers for the purchase of approximately 1.8 million shares of Reitz stock at $3.50 per share. However, on or about October 22, 1992, Dublin ceased its sales of Reitz stock when agents of the State of Ohio raided its offices and seized its records.

On or about January 1993, Hodge, Costello, Williamson, Gililland, and VanEcho became associated with MMC and Midwest. Midwest also employed approximately 20 other brokers and began offering to buy shares of common stock from the purchasers of the Reitz IPO.

Prior to January 15, 1993, Midwest purchased over 270,000 shares of Reitz stock at $1 .00 per share and 160,000 warrants at $.25 per warrant. Midwest paid $1.00 per share for the inventory of Reitz stock which it acquired prior to January 15, 1993, and it eventually paid

$1.25 for all of the inventory of Reitz stock which it purchased through the exercise of warrants.

Defendants began selling shares of Reitz stock to the public at a price of $3.50 per share. The price at which defendants sold Reitz stock remained steady until on or about February 26, 1993, when the price was raised to $3.75 per share. The price changed because Midwest's costs for Reitz stock had increased because it had sold all of the shares which it purchased for $1.00 and had to exercise warrants to obtain more shares, which cost it $1.25 per share. On or about April 7, 1993, defendants Eberle and Hodge decided to raise the price of Reitz stock to $4.00.

Between January 15, 1993, and on or about February 26, 1993, Midwest sold 216,100 shares of Reitz stock in 493 trades at $3.50 per share. Between on or about February 26, 1993 and on or about April 7, 1993, Midwest sold 138,700 shares of Reitz stock in 291 trades at $3.75 per share. Between on or about April 7, 1993 and on or about April 12, 1993, Midwest sold 10,000 shares of Reitz stock in 28 trades at $4.00 per share.

After a customer agreed to purchase Reitz stock, Midwest mailed a confirmation to the customer. The district court found that Midwest's confirmation was confusing to its own representatives because, from the face of the confirmation, an investor had no way of knowing whether the markup and commission information stated in the confirmation was for the total transaction or a markup and commission per share. J.A. 515. Also Midwest's brokers did not explain the codes on the confirmation to the customers.

With regard to Midwest's sales of Reitz stock to investors, the district court found, among other things: (1) that Midwest's brokers did not tell its customers what Midwest had paid for its inventory of Reitz stock; (2) that Midwest's brokers did not tell its customers that Midwest employees sold their units of Reitz stock and warrants to Midwest at a 75 percent profit; (3) that Midwest's brokers did not tell investors that the price of Reitz stock did not reflect free market supply and demand; (4) that Midwest's brokers did not tell customers that Midwest was the only market maker in Reitz stock; (5) that Midwest's brokers did not tell customers the actual amount of compensation which Midwest received as a result of sales of Reitz stock; (6) that Midwest' s brokers did not reveal the amount of the markup on Reitz stock to investors; (7) that Midwest's brokers did not reveal the amount of the commission that they received on

sales of Reitz stock; and (8) that Midwest's brokers told customers that Reitz stock was in great demand, would increase dramatically in price within one or two years, and would trade nationally within one or two years. J.A. 517.

After getting the necessary information from a customer over the telephone, the brokers at Midwest filled out a suitability form for a customer engaging in a transaction of Reitz stock. However, the brokers did not make the suitability determination; Midwest's compliance officer, Alan Clark, reviewed the suitability form and made the determination. If the compliance officer made a positive suitability determination, he sent the form to Midwest's accounting department, which mailed the form to the customer for a signature, along with a confirmation, which set forth the terms of the transaction. Out of about 800 transactions involving Reitz stock, Midwest questioned only about three to five for suitability.

Lastly, Midwest earned approximately $791,625 in gross revenue from the sale of Reitz stock to the public. Appellant's brief at 16. "Midwest's and MMC's cash receipts: and disbursements reports demonstrate that Eberle, Hodge, Costello, Gilliland, VanEcho and Williamson personally received $50,000, $52,600, $20,031, $32,664, $16,233 and $15,849, respectively, in connection with Midwest's sale of Reitz stock." Id.

B.

On April 12, 1993, plaintiff SEC filed an action in the district court seeking a temporary restraining order, a preliminary and permanent injunction, and other equitable relief against defendants, alleging that they had violated the Securities Act of 1933 and the Securities Exchange Act of 1934 ("Acts") through knowing and active participation in the sale of shares or stock at artificially inflated and manipulated prices including undisclosed excessive markups. A temporary restraining order was granted.

On May 3 and 4, 1993, the district court conducted hearings on the request for a preliminary injunction. On May 18, 1993, the district court issued an order granting the preliminary injunction, and, in the same order, made extensive findings of fact and conclusions of law in support of the preliminary injunction.

Subsequently, defendants sought to appeal the district court's grant of the preliminary injunction, filing a notice of appeal on August 13. 1993. On November 18, 1993, we dismissed the appeal for lack of jurisdiction,

finding that it was unripe because no final appealable judgment had been issued by the district court.

Meanwhile, plaintiff, the SEC, filed a motion seeking summary judgment on October 13, 1993, to which defendants responded on November 15, 1993. Thereafter, on March 31, 1994, the district court granted summary judgment for the SEC. In its order, the district court made permanent its preliminary injunction; held defendants jointly and severally liable for $791,625, the amount of trading profits on the sales of Reitz stock; ordered defendants Hodge and Eberle to pay civil penalties in the amount of $25,000 each; and ordered the remaining individual defendants, namely, VanEcho, Costello, Gilliland, and Williamson, to pay civil penalties of $10,000 each.

On April 14, 1994, defendants filed a timely notice of appeal. However, on that same date, the SEC filed several time-tolling motions under Fed. R. Civ. P. 59(e), including a request for an order freezing the assets of all the individual defendants pending satisfaction of the judgment a request for the appointment of a receiver for Midwest, a request to reopen the case, and a request to amend the judgment.

The SEC withdrew its request for the appointment of a receiver on August 23, 1994, and subsequently, defendants changed counsel. The matter was then referred to a magistrate judge who, in a report and recommendation issued on February 2, 1995, recommended that the motion to reopen the case and the motion for a freeze order be denied, and that the motion to amend the judgment be held in abeyance pending the submission of a proposed order by the SEC. Thereafter, an February 21, 1995, the parties submitted a stipulated proposed final judgment and order of permanent injunction and other equitable relief. In their stipulation to the proposed final judgment and order of permanent injunction and other equitable relief, the parties stated that they had "prepared and agreed upon the Proposed Final Judgment ... which is consistent with this Court's previously issued Order date [sic] March 31, 1994." J,A. 1239. The proposed final judgment and order of permanent injunction and other equitable relief provided, among other things, that defendants were jointly and severally liable for disgorgement of $791,625, and it assessed the same civil penalties against the individual defendants as were assessed in the district court's order of March 31, 1994. On March 16, 1995, the district court adopted the magistrate judge's report and recommendation of February 2, 1995, and signed the

parties' stipulated proposed final judgment and order of permanent injunction and other equitable relief[2].

II.

A.

In their brief, defendants argue, relying on the decision in United States v. Lopez, 115 S. Ct. 1624 (1995), that the Securities Act of 1933, and the Securities Exchange Act of 1934 were unconstitutionally applied to their offering and selling of securities wholly within the State of Ohio, Specifically, they assert that

> Congress cannot exercise its power over interstate commerce to protect actual and/or potential securities investors residing in an individual state from alleged intrastate securities fraud as it is not a legitimate end, i.e., it is not within the scope of its constitutional authority.

Appellant's brief at 26. Defendants further assert that "to the extent the Securities Act does not exempt securities offered and sold wholly within an individual state from the antifraud provisions of Section 17(a) of the Securities Act [15 USCS § 77Q(a)] it is unconstitutional." Id. at 27. However, at oral argument, defendants' counsel conceded that Lopez had no application to this case whatsoever.

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[2] Defendants did not file a second or amended notice of appeal following the district court's order of March 16, 1995. However, pursuant to Fed. R. App. P. 4(a)(4), their otherwise timely notice of appeal, filed on April 14, 1994, was suspended during the pendency of the Fed. R. Civ.P. 59 time-tolling motions, and it became effective when the district court disposed of the time tolling motions in its order of March 16 1995. See Nancy v. Dean, 32 F.3d 1521, 1523-24 (11th Cir. 1994) ("[A]n otherwise timely notice of appeal filed before the disposition of a Rule 59 motion is not voided but instead merely lies dormant while the motion is pending, and the notice of appeal becomes effective as of the date of the order disposing of the Rule 59 motion.").

However, if a party intends to challenge an alteration or amendment of a judgment, the new version of Rule 4(a)(4) requires the party to file a new or amended notice of appeal to challenge the alteration. See Reeves v. Collins, 27 F.3d 174, 177 (5th Cir, 1994) (per curiam). Nevertheless, we note that in this case the parties stipulated final judgment and order of permanent injunction and other equitable relief awards which were virtually identical to the district court's order of March 31, 1994. Thus, we conclude that defendants have not waived any of their arguments by virtue of their failure to file a second or amended notice of appeal.

Moreover, because defendants made extensive use of the mails to perpetrate their fraud, we conclude that the application of the Acts to defendants was a valid exercise of Congress' power under the Postal Clause, U.S. Const. Art. I, § 8, cl. 7. "The Constitution grants Congress plenary authority over the postal system" United States; v. Barry, 888 F.2d 1092, 1094 (6th Cir. 1989) (citing U.S. Const. Art. I, § 8)). Furthermore, where a statute is enacted based upon Congress' postal power, the fact that the mailings involved are wholly intrastate is immaterial because "the Postal Power Clause does not distinguish between interstate and intrastate matters." Smith v. United States, 431 U.S. 291, 305 (1977).

The courts have long expressly held that the antifraud provisions of the securities laws apply when the mails are used, even when the mailings are entirely intrastate. See Bogy v. United States, 96 F.2d 734, 737 (6th Cir.) ("Congress, under its power to establish post offices and post roads, Article I, Sec. 8, United States Constitution, has full control of the mails and may forbid their use in the execution of schemes to defraud."), cert denied, 305 U.S. 608 (1938)). Further, in Northern Trust v. Essaness Theatres Corp., 103 F. Supp. 954 (N.D. Ill. 1954), the defendant challenged the application of Section 10(b) of the Exchange Act because his business was wholly intrastate, being confined to the State of Nebraska. Id. at 962. The district court rejected defendants' argument holding that under the Postal Clause "no limitation to interstate business is ... applicable." Id. Thus, we conclude that the Acts were constitutionally applied to defendants in this case.

B.

Defendants argue that the district court erred in granting summary judgment in favor of the SEC under Section 10(b) and Rule 10b-5, Section 17(a)(l) and Section 15(c) of the Exchange Act because; (1) the district court failed to find that defendants acted with scienter as required by those provisions, and (2) the record shows that they did not act with the level of scienter required by the Acts. Defendants assert that the district court ruled without making an express finding of scienter in this case. Appellant's brief at 35. Specifically, they state:

> The only possible reference to scienter is [the district court's statement] that "[i]f defendants were unaware of the wrongfulness of

> their conduct, the Court can only conclude that they were blinded by their greed and desire for quick and disproportionate profits."

Id. (quoting J.A. 530).

Defendants' argument that the district court failed to make a finding of scienter as required under section 17(a)(1) of the Securities Act and Sections 10(b) and 15(c)(1) of the Exchange Act is meritless. In its March 1995 judgment, the district court specifically noted that defendants had "engaged in violations of the federal securities laws involving fraud and manipulation" J.A. 1243, and the judgment explicitly incorporated by reference "the reasons set forth in the Court's Findings of Fact, Conclusions of Law and Preliminary Injunction Order dated May 18, 1993, and the Court's Order dated March 31, 1994." J.A. 1241. Likewise, in its order of March 31, 1994, the district court stated that it would

> make the preliminary injunction permanent. In doing so, the Court incorporates the findings and conclusions set forth in its May 18, 1993 decision granting the preliminary injunction.

J,A. 529. In this order, the district court also made additional findings as to the nature of defendants' fraud, including that "defendants perpetrated a grave fraud on the investing public," that their "conduct was egregious and that both disgorgement and civil penalties are necessary to achieve justice," and that the "nature of [defendants'l fraud was apparent." J.A. 530. The court further stated that "[i]f the defendants were unaware of the wrongfulness of their conduct, the Court can only conclude that they were blinded by their greed and desire for quick and disproportionate profits." Id.

Furthermore, in its May 18, 1993 order granting a preliminary injunction, the district court made the following findings:

> 7. The Defendants have made misstatements and omitted to state material facts to investors about the offer and sale of Reitz securities. These include the following: that Midwest did not base the price it charged for Reitz stock on a free, open, and competitive market and that Midwest dominated and controlled the market in Reitz stock. These misstatements and omissions operated as a fraud and deceit about the nature of the market.

> 8. The Defendants knew or, at a minimum, were reckless in not knowing that the markups Midwest charged in the sales of Reitz stock were excessive. They also knew that they had not based the price Midwest charged on a free, open, and competitive market. They knew that the price was not reasonably related to the prevailing market price. *Thus they acted with scienter.*

J.A. 519 (Emphasis added). Thus, contrary to defendants' assertions, we conclude that the district court made findings of scienter of a sufficient nature to satisfy the statutes.

"[S]cienter is a necessary element of a violation of § 10(b) and Rule 10b-5." Aaron v. SEC, 446 U.S. 680, 695 (1980). "The language of § 17(a) strongly suggests that Congress contemplated a scienter requirement under § 17(a)(1), but not under § 17(a)(2) or § 17(a)(3)." Id. at 695-96, "Recklessness is a sufficiently culpable state of mind for liability under § 10(b) and Rule 10b-5." Mansbach v. Prescatt. Ball & Turben, 598 F.2d 1017, 1023 (6th Cir. 1979); SEC v. Blavin, 760 F.2d 706, 711 (6th Cir. 1985) (per curiam). "Recklessness is "highly unreasonable conduct which is an extreme departure from the standards of ordinary care.'" Blavin. 760 F.2d at 711 (quoting Ohio Drill & Tool Co. v. Johnson, 625 F2d 738, 741 (6th Cir. 1980)). A reckless omission has also been defined as:

> a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

Sunstrand Corp.. v. Sun Chem. Corp., 553 F.2d 1033, 1045 (7th Cir.), cert. denied, 434 U.S. 875 (1977) (quoting Franke v. Midwestern Okla. Dev. Auth., 428 F. Supp 719, 725 (W.D. Okl. 1976).

The SEC asserts that during the proceedings in the district court, defendants abandoned their argument that they lacked a sufficient level of scienter to violate the antifraud statutes, and, therefore. they have waived their right to challenge the district court's finding of scienter in this appeal. We agree. In their response to the SEC's motion for summary judgment,

which was filed after the district court issued its preliminary injunction, defendants stated that the parties were in agreement that "judicial . . . economy would be promoted by a motion for summary judgment" and that "it is unlikely that such a motion by Defendants would result in reversal of the Preliminary Order . . . ." J.A. 477. The response then stated:

> In support of its motion, Plaintiff has delivered to Defendants (and has no doubt filed) thousands of pages of deposition copies and other documents. After a great deal of both labor and thought, counsel for Defendants has concluded that any effort to respond to that mass of detail would . . . produce little, if any, benefit to anyone. J.A. 477.

Further, even were we to address the issue, a review of the record reveals no genuine issue of material fact regarding the issue of scienter. The defendants, all of whom had purchased the IPO of Reitz Data stock knew that Midwest had purchased the stock from them at $1.00 or $1.25 per share, and they knew that Midwest was reselling the stock to the investing public at prices which ranged from $3.50 to $4.00 per share. Defendants also knew that during the relevant period of this case, Midwest was the only firm buying and selling Reitz stock and that the only other firm even quoting a price for the stock was doing so "subject to retail." Further, defendants knew that Midwest set the asking price for Reitz stock based upon the price that Dublin Securities was asking for the stock, as well as its own need to generate income.[3]

C.

Defendants also argue that the district court erred in ordering disgorgement of the profits from their sale of Reitz Data stock.[4] They assert that any violations of sections 17(a)(2) and 17(a)(3) should not require to result in disgorgement because violations of those sections do not require scienter. They further assert that because the record shows that some

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[3] Defendants also place great emphasis on a script, J.A. 722, which was allegedly read to customers. Defendants assert that this script disclosed all the relevant information to the customers. However, the evidence suggests that defendants did not begin using this script until sometime late in February or early in March 1993, and at least one of Midwest's brokers testified that he never read the disclosure to any customer before they agreed to buy Reitz data stock. J.A. 1215.

investors were inclined to purchase Reitz data stock because of their prior contact with Dublin Securities, not all or Midwest's sales of Reitz data stock should be deemed fraudulent.

However, although scienter is not required for violations of sections 17(a)(2) and 17(a)(3), the district court did find that defendants acted with scienter. Furthermore, although the record does show that some investors were aware of, and perhaps favorably inclined to, the possibility of purchasing Reitz data stock based upon their earlier contact with Dublin Securities, the record further shows that Midwest nonetheless failed to disclose material information to these investors when it contacted them.

"In the exercise of its equity powers, a district court may order the disgorgement of profits acquired through securities fraud." SEC v. Patel, 61 F.3d 137, 139 (2d Cir. 1995). "The purpose of disgorgement is to force .a defendant to give up the amount by which he was unjustly enriched rather than to compensate the victims of fraud." Blavin, 760 F.2d at 713 (quoting SEC v. Commonwealth Chem. Sec.. Inc, 574 F.2d 90, 102 (2d Cir. 1978)). See also SEC v. Bilzerian. 29 F.3d 689, 697 (D.C. Cir. 1994) ("The primary purpose of disgorgement is not to refund others for losses suffered but rather 'to deprive the wrongdoer of his ill-gotten gain.'") (quoting SEC v. Blatt, 583 F.2d 1325, 1335 (5th Cir. 1978)). Moreover, "[o]nce the [SEC] has established that a defendant has violated the securities laws, the district court possesses the equitable power to grant disgorgement without inquiring whether, or to what extent identifiable private parties have been damaged by . . . fraud." Blavin, 760 F.2d at 713. Thus, we conclude that the district court's order of disgorgement was within its equitable powers and that defendants' challenge to the order of disgorgement is meritless.

III.

For the reasons stated, the district court's judgment is AFFIRMED.

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[4] The SEC argues that defendants have waived their challenge to the district court's imposition of disgorgement because they (1) never raised, or (2) abandoned the issue below. We disagree. In their response to the SEC's motion for summary judgment, defendants strenuously argued against the imposition of "disgorgement" and "civil penalties." J.A. 477-80. Thus, we find that defendants' challenge to disgorgement was neither waived nor abandoned.

APPENDIX C - DECISION BY UNITED STATES DISTRICT COURT DATED MARCH 31, 1994

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF OHIO

SECURITIES AND EXCHANGE COMMISSION Plaintiffs	CASE NUMBER: C2-93-389
v.	JUDGE SMITH Magistrate Judge Kemp
MIDWEST INVESTMENTS, INC., et al. Defendants	**JUDGMENT IN A CIVIL CASE**

Decision by Court. This action came to trial or hearing before the Court. The issues have been tried or heard and a decision has been rendered.

IT IS ORDERED AND ADJUDGED that pursuant to the 3/31/94 Order by Judge Smith, final judgment is entered in favor of plaintiff, against defendants, jointly and severally, in the amount of $791,625. Judgment is also entered in favor of plaintiff, against the individual defendants as follows: against dft Robert D. Hodge in the amount of $25,000; against dft Michael J. Eberle in the amount of $25,000; against dft Thomas J. VanEcho in the amount of $10,000; against dft Thomas L. Costello in the amount of $10,000; against dft Donald H. Gilliland in the amount of $10,000; and against dft Thomas J. Williamson in the amount of $10,000. This action is hereby DISMISSED.

Date: March 31, 1994

KENNETH J. MURPHY
Clerk

/s/ Michael Carey
(By) Deputy Clerk, Michael Carey

APPENDIX D - ORDER OF UNITED STATES DISTRICT COURT DATED MARCH 31, 1994

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF OHIO
EASTERN DIVISION

SECURITIES AND EXCHANGE COMMISSION
Plaintiffs

v.

MIDWEST INVESTMENTS, INC., et al.
Defendants

CASE NUMBER: C2-93-389

JUDGE SMITH
Magistrate Judge Kemp

ORDER

This action involves the sale of penny stocks by an intrastate broker-dealer. This matter is before the Court on plaintiff's motion for summary judgment.

The Court issued a preliminary injunction on May 18, 1993, inter alia, finding that defendants' activities had violated the anti-fraud provisions of federal securities law, and enjoining defendants from selling stock or disposing of assets. Soon after the Court issued the preliminary injunction, defendants, who desired to avoid the possibility of two appeals, filed a motion to make permanent the preliminary injunction. Plaintiff opposed the motion on the ground that because the preliminary injunction hearing was held such a short time after the filing of the action, it had not had sufficient opportunity to take discovery and make a complete record to defend any permanent injunction on appeal. The Court agreed with plaintiff that it should be given the opportunity to make a more complete record, and the parties ultimately agreed to submit the matter on cross-motions for summary judgment.

Plaintiff filed its 105 page (exclusive of exhibits) motion for summary judgment on October 13, 1993. Defendants filed their five (5) page memorandum contra on November 15, 1993. Plaintiff filed its reply thereto on December 2, 1993.

While defendants disagree with the findings and conclusions underlying the Court's preliminary injunction order, they do not, as a practi-

cal matter, oppose the entry of a permanent injunction. Such a result would, of course, be in keeping with their earlier motion to make permanent the preliminary injunction. The Court will therefore make the preliminary injunction permanent. In doing so, the Court incorporates the findings and conclusions set forth in its May 18, 1993 decision granting the preliminary injunction.

One matter not addressed in the Court's preliminary injunction order, however, is the issue of the equitable remedy of disgorgement or other monetary remedies. Specifically, plaintiff asserts that defendants should be held liable for the amount of trading profits, $791,625, or the total value each defendant received as a result of the subject transactions. Plaintiff also maintains that the Court should impose civil penalties of $100,000 against each individual defendant, and $791,625 against defendant Midwest Investments, Inc, Defendants argue that because the instant case was one of first impression, the Court should not order disgorgement or impose civil penalties. Defendants do not dispute the amount of trading profits plaintiff alleges resulted from the subject transactions.

The Court finds that defendants' conduct was egregious and that both disgorgement and civil penalties are necessary to achieve justice in this case. Specifically, defendants perpetrated a grave fraud on the investing public. Defendants manipulated, and in reality controlled, the price of Reitz Data Communications, Inc. The prices defendants selected had little if any relation to the actual value of the stock. Defendants omissions and misrepresentations concealed from investors the enormous profits to defendants included in the price.

Moreover, although these exact circumstances have not arisen before this case, the Court finds that the nature of the fraud was apparent. Defendants cannot hide behind the novelty of their scheme. For example, it has long been recognized that the antifraud provisions of both § 10(b) of the of the 1934 Act and Rule 10b-5 apply to the sale of "any security." See Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6, 10-12 (1971). If defendants were unaware of the wrongfulness of their conduct, the Court can only conclude that they were blinded by their greed and desire for quick and disproportionate profits.

The Court finds that disgorgement is an appropriate and necessary remedy in this case. Based upon the personal involvement and knowledge of each defendant, defendants shall be held jointly and severally liable for the amount of $791,625. The Court also finds that in light of

their egregious behavior, the individual defendants shall be subject to civil penalties under 15 U.S.C. §§ 77t(d) and 78u(d) (3) as follows: against defendants Robert D. Hodge and Michael J. Eberle in the amount of $25,000 each; against the remaining individual defendants in the amount of $10,000 each. These amounts reflect that defendants Hodge and Eberle are more culpable than the other individual defendants. The Court finds that given the scope and nature of defendants' activities, and the profits they reaped, these amounts are the least severe civil penalties that would likely deter them from future misconduct. The Court declines to impose prejudgment interest.

In sum, plaintiff's motion for summary judgment (Doc. 97) is **GRANTED**. Accordingly,

1. The Court PERMANENTLY ENJOINS defendants and their agents from selling or offering for sale Reitz stock or any other securities in violation of any securities laws as described in the Conclusions of Law issued by the Court in this case on May 18, 1994.

2. The Court PERMANENTLY ENJOINS defendants and their agents from selling or offering for sale Reitz stock or any securities to the public without first obtaining written permission of the Court, and after providing the Commission twenty (20) days notice of all of the appropriate details of the proposed offer or sale.

3. The Court PERMANENTLY ENJOINS defendants and their agents, and any persons who receive actual notice of this Order, from transferring or disposing of any funds or assets of Midwest without first obtaining written permission of the Court, and after providing the Commission seven (7) days notice of all of the appropriate details of the proposed transfer or disposal.

4. The Court PERMANENTLY ENJOINS defendants and their agents, and any persons who receive actual notice of this Order, from destroying, mutilating, altering, or concealing any books, records documents, computer data, correspondence, brochures, manuals, obligations, or other property of or pertaining to defendant Midwest, wherever located.

Furthermore, the Clerk shall enter a final judgment in favor of plaintiff, against defendants, jointly and severally, in the amount of $791,625. The Clerk shall additionally enter a judgment in favor of plaintiff, against the individual defendants as follows: against defendant Robert D. Hodge in the amount of $25,000; against defendant Michael J.

Eberle in the amount of $25,000; against defendant Thomas J. VanEcho in the amount of $10,000; against defendant Thomas L. Costello in the amount of $10,000; against defendant Donald H. Gilliland in the amount of $10,000; and against defendant Thomas J. Williamson in the amount of $10,000.

The Clerk shall remove this case from the Court's pending cases and motions lists.

IT IS SO ORDERED.

/s/ George C. Smith
GEORGE C. SMITH, JUDGE
UNITED STATES DISTRICT COURT

APPENDIX E - DISTRICT COURT'S FINDINGS OF FACT, CONCLUSIONS OF LAW AND PRELIMINARY INJUNCTION ORDER DATED MAY 18, 1993

UNITED STATES DISTRICT COURT
SOUTHERN DISTRICT OF OHIO
EASTERN DIVISION

SECURITIES AND EXCHANGE COMMISSION Plaintiffs v. **MIDWEST INVESTMENTS, INC., et al.** Defendants	CASE NUMBER: C2-93-389 JUDGE SMITH Magistrate Judge Kemp

FINDINGS OF FACT CONCLUSIONS OF LAW AND PRELIMINARY INJUNCTION ORDER

This is a securities action about the sale of penny stocks by an intrastate broker-dealer. The Court held a preliminary Injunction hearing in this matter on May 3 and 4, 1993. The Court makes the following Findings of Fact and Conclusions of Law:

I. FINDINGS OF FACT

1. Defendant Midwest Investments, Inc. (Midwest) is a broker-dealer. The State of Ohio licensed Midwest to sell securities. Midwest's principal place of business is in Columbus, Ohio. It formerly called itself Columbus Skyline Securities Company (Columbus Skyline). The name change took place in January 1993. Defendant Michael J. Eberle (Eberle) was the president and owner of Columbus Skyline.

2. An entity known as Midwest Management Company (MMC) owns Midwest. A contract between MMC and Midwest provides that MMC shall receive $120,000 per month as payment for the services it provides to Midwest. As agreed between Defendant Eberle and Defendant Robert D. Hodge (Hodge), Eberle transferred 80% of MMC to Hodge's wife in exchange for their services. Hodge transferred 25% of

his interest in MMC to others in exchange for their services. The transfers were as follows: 5% to Defendant Donald H. Gilliland (Gilliland) , 5% to Mary Anne Williamson, the wife of Defendant Thomas J. Williamson (Williamson), 5% to Defendant Thomas L. Costello (Costello), 5% to Defendant Thomas J. VanEcho (VanEcho) and 5% to Danos Tiano (Tiano). Eberle is the President of MMC and Midwest and each of the 5% owners is a Vice-President of MMC.

3. Eberle held a license to sell securities issued by the State of Ohio. Eberle and Midwest are now the subject of an order by the Ohio Division of Securities revoking their licenses. Eberle, as President of Midwest and MMC, supervises the operation of the firm. Eberle is responsible for supervision of the salesmen in the office and for approving or disapproving documentation used in the Sales room. Eberle and Hodge, along with Defendants Costello, Gilliland, VanEcho and Williamson, are responsible for compliance matters at the firm. Eberle and Hodge are responsible for deciding the prices that Midwest quotes for stocks.

4. Dublin Securities, Inc. (Dublin), a broker-dealer formerly licensed by the State of Ohio, employed Hodge. Hodge became associated with MMC in January 1993, and is a Vice-President of MMC. Hodge supervises Costello, Gilliland, VanEcho, Williamson and all of the other brokers at Midwest.

5. Costello, Gilliland, VanEcho and Williamson all worked at Dublin before they began working at Midwest. All four are sales managers for Midwest and are responsible for supervising the Midwest brokers. All four hold licenses to sell securities in Ohio.

6. Larry Reitz incorporated Reitz Data Communications, Inc., (Reitz) on October 15, 1984. Larry Reitz is also the President Of Reitz. Reitz is in, the business of designing and installing computer systems for industrial, medical and police applications. Reitz now employs eight individuals. Since incorporation in 1984, there have been one to two years during the 1980's in which Reitz made a profit. The profit earned by Reitz during each of those two years was less than $50,000. As of June 30, 1992, Reitz had a net worth of negative $92,352.61. As of October 20, 1992, Reitz had a book value per share of $.12. For the period January 1, 1992 to October 20, 1992 Reitz had a net loss of $67,953.53. For the first quarter of 1993, Reitz had a net loss of about $80,000. Reitz has never had revenue or a net worth of more than $2,000,000,

7. In or about September 1992, Reitz registered an initial public

offering (IPO) of 500,000 units of Reitz stock with the Ohio Division of Securities (ODS). Each unit had a sales price of $1. Each unit consisted of one share of class A common stock and three warrants to purchase additional shares of class A common stock at a price of $1 per share. Reitz did not register the offering with the Commission. No one has ever traded Reitz securities on any national exchange. No one has ever quoted Reitz securities on any national quotation service. Reitz securities are not pending approval for trading on any national exchange or quotation on any national quotation service.

8. After the offering was complete, Reitz had 500,000 shares of class A common stock outstanding and 3,000,000 shares of class B common stock outstanding. In addition, Reitz reserved 1,500,000 class A common shares for issuance upon exercise of warrants. Reitz restricted class B common shares and they may not be transferred for 4 years. During September 1992, Dublin Management, Inc. bought 1,200,000 of the Reitz class B common shares for $15,000, or $.0125 per share.

9. No investment company registered under the Investment Company Act of 1940 has ever issued Reitz securities. The Options Clearing Corporation has never issued Reitz securities as put or call options.

10. Dublin arranged for the sale of the Reitz units to a group of individuals. In September 1992, Tony Kohl, the treasurer of Dublin, arranged the offering. He provided Larry Reitz with a list of names of persons to buy the IPO. Kohl collected the checks from these persons. Kohl gave Reitz a script to use in selling the initial public offering to the people on the IPO list. Most of the persons purchasing the Reitz units were employees of Dublin and friends and relatives of Dublin employees. Dublin employees called these individuals "insiders."

11. Hodge bought 10,000 units in the Reitz offering at $1 per unit. Hedge also provided names of other potential purchasers of units to Dublin in the list given to Larry Reitz. Costello, VanEcho, and Gilliland each bought 5,000 Reitz units, as insiders, at a price of $1 per unit. Williamson bought 1,500 Reitz units, as an insider, at a price of $1 per unit. The insiders were led to believe that they could resell their shares of Reitz common stock to Dublin at a price of $1 per share and to resell their warrants to Dublin at a price of $.25 each. Dublin collected the checks in the Reitz offering. The bank dishonored checks totaling about $45,000.

12. Dublin began selling shares of Reitz to the public on October,

20, 1992. Dublin brokers received agreements from customers to purchase 1.8 million shares of Reitz stock at $3.50 per share. On or about October 22, 1992, Dublin stopped selling Reitz stock at near the same time the Stare of Ohio seized its records.

13. Before December 25, 1992, Hodge told Larry Reitz that he was making arrangements with Midwest to market Reitz stock. Hodge told Reitz that he was aware that the bank dishonored about $45,000 of the checks received for the Reitz offering. Danos Tiano works for MMC. He contacted Reitz during the last week in December 1992 to purchase any units from Reitz which remained unsold at the end of 1992. Tiano told Larry Reitz that he could buy the remaining units. Larry Reitz sold a portion of the remaining 45,000 IPO units to persons located near the Toledo, Ohio, area. He also sold about 26,000 units to Tiano.

14. In or about January 1993. Hodge, Costello, Williamson, Gilliland, and VanEcho became associated with MMC and Midwest. In addition, over 20 other Dublin brokers became employed by Midwest.

15. In January 1993, Hodge called Larry Reitz to get the list of people who had bought the Reitz Stock and warrants from Dublin in the IPO. Eberle did not know of any broker-dealer, other than Dublin, that had a copy of the list. Eberle, VanEcho and the other Defendants then began calling the people on the list. The Defendants bought Reitz shares from them at a price of $1 per share. They also bought warrants at a price of $.25 per warrant. Eberle, VanEcho and the other Defendants tried to contact all the persons on the IPO list. Hodge and Eberle established the $1 and $.25 prices based on Dublin's representation to the purchasers of the units that they would receive those prices for their shares and warrants on resale.

16. VanEcho contacted at least twenty to twenty-five of the insiders to buy their Reitz IPO securities. VanEcho told the Insiders he contacted that Midwest was willing to pay $1 per share and $.25 per warrant. During VanEcho's contacts, he told the Insiders the bid and asked price that Midwest was going to quote when it began selling Reitz stock. The insiders with whom VanEcho spoke did not try to negotiate the price for their Reitz stock and warrants. Moreover, they did not ask to receive the bid price that Midwest planned to quote. VanEcho did not ask to buy the insiders' Reitz warrants. This is because Midwest only wanted Reitz stock at that time. Hodge, Costello, VanEcho,

Williamson and Gilliland all sold their Reitz IPO shares and warrants to Midwest at prices of $1 per share and $.25 per warrant.

17. Midwest, in its first 63 transactions in Reitz stock, which occurred before January 15, 1993, got over 270,000 shares of Reitz stock at $1 per share and over 160,000 warrants at $.25 per warrant. Midwest was unable immediately to pay for the shares and warrants it got from the insiders, Midwest paid the insiders for their shares and warrants within five days of purchase with the proceeds from the sale of Reitz stock to the public. Of the remaining 230,000 shares and 1,340,000 warrants, Clarence Eyerman, former president of Dublin, had bought 206,500 shares and 619,000 warrants,

18. Midwest paid $1 per share for its Inventory of Reitz stock acquired before January 15, 1993. Midwest paid $.25 per warrant for its inventory of Reitz warrants. Midwest paid $1.25 for the all of its inventory of Reitz stock bought through the exercise of warrants.

19. Eberle, Hedge, Costello, Williamson, VanEcho and Gilliland, together, decided to set the initial price of Reitz to the public at $2.75 bid and $3.50 asked. They based the decision to price the stock at $3.50 asked on the bills and overhead costs of Midwest. They also considered Midwest's need to make a certain profit on the Reitz sales. Eberle also considered the price Dublin had initially charged the public in sales of Reitz stock. In pricing the stock at $3.50, Eberle did not look at the quotes of other broker-dealers contained in a quotations service called the Ohio yellow sheets (yellow sheets). The prices set by Midwest for Reitz stock were arbitrary.

20. The price at which Defendants sold Reitz stock to the public remained at $2.75 bid and $3.50 asked per share until on or about February 26, 1993. At that time Eberle and Hodge raised the price to $3.00 bid and $3.75 asked per share. The reason for the change in price was that Midwest's cost for Reitz stock increased since Midwest had sold all the shares it had bought for $1 and had to exercise warrants to acquire more shares (which cost Midwest $1.25 per share). Eberle stated that the quotes other broker dealers entered for Reitz stock did not influence Eberle's decision to raise the price for Reitz stock. He said this was because all that mattered to him in raising the price was the increased cost to Midwest. Defendants based the price for Reitz stock only on Midwest's own supply and demand.

21. On or about April 9, 1993, Defendants Eberle and Hodge

decided to raise the asked price of Reitz stock to $4. They based their decision in part on Midwest's low inventory position in Reitz. In raising the price for Reitz stock to $4 per share, Eberle did not try to find out whether any other brokerage firm was buying or selling Reitz stock.

22. On or about January 11, 1993, Midwest, through Eberle and Hodge, bought from Dublin a list of customers who had expressed interest in purchasing Reitz stock from Dublin. They paid $.20 per name for the list. On January 15, 1993, Costello, Gilliland, VanEcho, Williamson and brokers subject to their supervision began selling Reitz to the public at $3.50 per share. Midwest's brokers each made between 50 and 100 telephone calls per day in selling Reitz stock to the public. Midwest has about a 10% to 20% cancellation rate on its sales of Reitz stock.

23. Between January 15, 1993 and about February 26, 1993, Midwest sold 216,100 shares of Reitz stock in 493 trades at $3.50 per share. Between about February 26, 1993 and about April 7, 1993, Midwest sold 138,700 shares of Reitz stock in 291 trades at $3.75 per share. Between about April 7, 1993 and about April 12, 1993, Midwest sold 10,000 shares of Reitz stock in 28 trades at $4.00 per share.

24. On February 17, 1993, the Commission's staff sent Midwest a subpoena requesting documents concerning to its sales of Reitz stock.

25. From February 22, 1993 until April 12, 1993, Midwest executed eleven purchase transactions at its quoted bid price for a total of 9,500 shares. On February 22, March 5, March 10, March 15, March 16, and March 22, of 1993, Midwest bought 3,000, 100, 1,000, 100, 100, and 100 shares, respectively, from Nathan Hodges. Midwest got these shares from Hodges at its quoted bid price. Nathan Hedges was a broker at Dublin and an insider in the Reitz offering. On March 5, 8, 9, and 10 Midwest made 13 purchases of a total of 81,000 warrants at $.25 per warrant. On March 26, 1993, Midwest bought 2,600 shares of Reitz stock from Nathan Hodges for $1.05 per share. At the same time, it bought 5,000 warrants from Hodges at $.25 per warrant.

26, The yellow sheets are a quotation service for stocks in the State of Ohio run by the Ohio Dealer Data Service (ODDS). The quotations in the yellow sheets give the bid and asked price quoted by a broker-dealer. The information in the yellow sheets is not published in the newspaper unless the broker-dealer places the information in

the paper.

27. Dublin quoted a bid and asked price in the yellow sheets for Reitz stock in October 1992. While Dublin quoted Reitz stock, M.C. Capital Corporation (M.C. Capital), a broker-dealer registered with the State of Ohio, also quoted Reitz stock. During December 1992, M.C. Capital was the only broker-dealer quoting Reitz stock in the yellow sheets. During January through April 12, 1993, M.C. Capital and Midwest were the only broker-dealers quoting Reitz stock in the yellow sheets.

28. M.C. Capital quoted Reitz stock in the yellow sheets "subject to retail." "Subject to retail" means that, if a customer contacts the brokerage firm to sell stock, the brokerage firm will not buy the stock without having a retail buyer willing to acquire the stock.

29. On October 23, 1992, the State of Ohio seized Dublin's records. The next day M.C. Capital quoted $2 1/2 bid and $3 1/2 asked. On December 16, 1992, M.C, Capital quoted $1 bid and $1.25 asked for Reitz stock. During November and December of 1992, M.C. Capital began quoting Reitz "subject to retail." It also dropped its quoted price to $1 bid and $1.25 asked for Reitz. It did so because it did not want to purchase Reitz stock from clients calling to "dump" the stock after Dublin stopped trading the stock,

30. On January 18, 1993, Midwest quoted a bid price of $2.75 and an asked price of $3.50. From January 18, 1993 until February 25, 1993, M.C. Capital was quoting an asked price of $.50 less than Midwest. M.C. Capital, however, did not receive any calls from investors interested in purchasing the stock.

31. M.C, Capital determined the price that it quoted for Reitz by matching quotations by Dublin and Midwest. M.C. Capital did not engage in any actual trades in Reitz stock until about April 21, 1993. It then stopped quoting Reitz stock "subject to retail." M.C. Capital did not ask for or try to purchase or sell Reitz stock before April 21, 1993.

32. During the period that Midwest was selling Reitz stock, Eberle knew of no other broker-dealer who was buying or selling Reitz stock. Larry Reitz was not aware of any purchases or sales of Reitz stock by any broker-dealers other than Midwest and Dublin.

33. Midwest has never entered into any trades in Reitz stock with other broker-dealers.

34. From January 15, 1993 until April 12, 1993, the sale of

Reitz stock generated most of Midwest's revenue.

35. Midwest pays its salespersons $.50 per share for the sale of Reitz stock. They do not receive any pay when a customer sells stock. Additionally, the salespersons are to receive 20% of Midwest's net profits at the end of the year. The sales managers also receive an override on the volume of sales by the salesmen.

36. Midwest sends a confirmation to its customers after they agree to purchase Reitz stock. On the front of the confirmation, a box marked "Exch" means that Midwest is acting as agent in transactions in Reitz stock. Another box on the front of the confirmation, labeled "Orig," indicates that Midwest is acting as dealer for its own account. Midwest's confirmation is confusing to its own representatives. From the face of the Midwest confirmation, an investor has no way of knowing whether the markup and commission information disclosed in the confirmation is for the total transaction or a markup and commission per share.

37. Investors in Reitz stock read the purchase price and the name of the stock on the confirmation, but may not read the codes on the confirmation. Midwest brokers do not explain the codes.

38. Larry Reitz gave information to Midwest in documents with the caption "press release." Reitz, however, never released any of these documents to any newspaper. Midwest edited the press releases that Larry Reitz sent to Hodge. Larry Reitz originally sent information on the dollar values of the orders described in the press releases. Hodge, however, told Reitz that Midwest would rather not put information on the dollar value of orders in the press releases. Since the Reitz IPO, orders placed for Reitz products by its customers have ranged in value from $200 to $15,000.

39. The Commission's staff found a script on several brokers' desks at Midwest's offices. The script states: "To insure that G.M. will get parts that are exactly the same from two or more suppliers, GM has given Reitz Data an exclusive right to sell, install and instruct specific software, designed by Reitz to all companies who want to supply to GM." The exclusive right the script describes does not exist.

40. Midwest brokers have used a variety of materials in selling Reitz stock to customers. In addition, a Midwest broker used scripts marked as Plaintiff's deposition exhibits 34 and 35.

41. Midwest brokers do not tell investors what Midwest paid for its supply of Reitz stock. Midwest brokers do not tell investors

that Reitz sold its IPO to employees of Dublin and to the friends and family of Dublin employees at the price of $1 for a unit consisting of 1 share of stock and 3 warrants. Midwest brokers do not tell their customers that employees of Midwest have sold their shares of Reitz stock and warrants to Midwest for a 75% return on their initial investments,

42. Midwest brokers do not state to investors that it manipulates the price of Reitz stock.

43. Midwest brokers do not state to investors that the price for Reitz stock does not reflect free market forces of supply and demand.

44. Midwest brokers do not tell investors that the price for Reitz stock does not reflect the prevailing market price for Reitz stock.

45. Midwest brokers do not state whether Midwest was acting as principal or agent.

46. Midwest brokers do not state that Midwest was the only market maker in Reitz stock.

47. Midwest brokers do not tell customers that Midwest has not been consistently purchasing and selling Reitz stock in interdealer trades at its bid or offer price.

48. Midwest brokers do not tell customers the actual compensation received by Midwest in Reitz transactions.

49. Midwest does not state to investors the amount of Midwest's markup.

50. VanEcho, and other brokers at Midwest, do not tell investors what they receive in commissions on Reitz trades.

51. Midwest brokers state that Reitz stock is in great demand.

52. Midwest brokers tell investors that the price of Reitz stock will increase dramatically within one or two years. Midwest brokers also tell investors that Reitz stock will trade nationally within one or two years.

53. The Midwest brokers fill out a suitability form for a customer engaging in a transaction by getting information from the customer over the telephone. Midwest brokers do not make any suitability determination for their own customers. After Midwest's compliance officer reviews the suitability form, he sends it to Midwest's accounting department. Midwest mails the form to the customer for signature along with the confirmation, which contains the terms of the transaction. Out of over 800 transactions with about 600 different customers of Midwest, Midwest questioned only 3 to 5 trades based on suitability.

54. MBD Transfer is the transfer agent for Reitz stock, MBD Transfer documents all changes in ownership of Reitz stock. MMC owns 100% of MBD Transfer.

52. Midwest does not send its customers monthly account statements.

II. CONCLUSIONS OF LAW

1. The Defendants charged investors in Reitz stock excessive undisclosed markups of 152% in 493 transactions , 170% in 291 transactions and 188% in 28 transactions.

2. The Defendants have made misstatements and omitted to state material facts to investors about the offer and sale of Rietz securities. Specifically, they did not tell customers that the price Midwest charged did not reasonably reflect the prevailing market price for Reitz stock.

3. The disclosure of markups in Midwest's confirmation is inadequate. It does not provide complete, accurate, and intelligible information to investors about their securities transactions in Reitz stock. It does not enable investors to make intelligent investment decisions based on the confirmation.

4. The Defendants affected a series of Reitz stock transactions which created actual and apparent active trading in Reitz stock.

5. Midwest dominated and controlled the market in Reitz stock from January 15, 1993 until April 12, 1993.

6. Defendants represented to investors that they sold Reitz at the market price. Defendants, however, used their control of the supply and demand for Reitz to establish and maintain artificially high prices for Reitz Stock which did not reasonably reflect prices prevailing in a market which was free, open, and competitive.

7. The Defendants have made misstatements and omitted to state material facts to investors about the offer and sale of Reitz securities. These include the following: that Midwest did not base the price it charged for Reitz stock on a free, open, and competitive market and that Midwest dominated and controlled the market in Reitz stock. These misstatements and omissions operated as a fraud and deceit about the nature of the market.

8. The Defendants knew or, at a minimum, were reckless in not knowing that the markups Midwest charged in the sales of Reitz Stock were excessive. They also knew that they had not based the

price Midwest charged on a free, open, and competitive market. They knew that the price was not reasonably related to the prevailing market price. Thus, they acted with scienter.

9. The Defendants told investors that they offered Reitz stock "at the market" or at a price related to the market price. Defendants, however, neither knew nor had reasonable grounds to believe that a market for the Reitz existed other than that Midwest and persons associated with it controlled.

10. Defendants have, in the offer and sale of Reitz securities by use of means and instruments of transportation and communication in interstate commerce and by the use of the mails, directly and indirectly: (1) employed devices, schemes, and artifices to defraud investors in Reitz securities; (2) got money and property by untrue statements of material fact and by failures to state material facts necessary to make the statements not misleading; and (3) engaged in transactions, practices and courses of business which operated and would operate as a fraud and deceit upon the purchasers of Reitz securities. This conduct violated §§ 17(a)(1), (2), and (3) by of the Securities Act of 1933 (Securities Act).

11. Defendants, Midwest, Eberle, Hodge, Costello, Gilliland, VanEcho and Williamson, have directly and indirectly, by the use of any means and instrumentality of interstate commerce, and of the mails and of any facility of any national securities exchange: (1) employed devices, schemes, and artifices to defraud; (2) made untrue statements of material facts and omitted to state material facts necessary in order to make the statements not misleading; and (3) engaged in acts, practices, and courses of business which operated and would operate as a fraud and deceit upon any person; in connection with the purchase and sale of Reitz securities. This conduct violated § 10(b) of the Exchange Act and Rule 10b-5 promulgated thereunder.

12. Defendant Midwest, as a broker or dealer, has made use of the mails and other means and instrumentalities of interstate commerce to effect transactions in, and to induce and try to induce the purchase and sale of Reitz securities while: (1) engaging in acts, practices, and courses of business which operated as a fraud and deceit upon the purchasers of Reitz securities; and (2) making untrue statements of material facts and omitting to state material facts necessary to make the statements not misleading. Defendant Midwest made such misstatements and omissions with knowledge or reasonable grounds to believe that the facts

were untrue and misleading. Hence, Defendant Midwest has violated § 15(c) of the Exchange Act and Rules 15cl-2 and 15cl-8 announced thereunder.

13. Defendants Eberle, Hodge, VanEcho, Williamson, Gilliland and Costello have aided and abetted Defendant Midwest's violations of § 15(c) of the Exchange Act and Rules 15cl-2 and 15cl-8 promulgated thereunder, with a general awareness that their roles were part of an overall improper activity. They did this by providing knowing and substantial assistance to Midwest's manipulation of the price of Reitz stock, to Midwest's charging public customers prices which contained excessive undisclosed markups, and to Midwest's falsely representing to customers that the price at which they were purchasing Reitz stock related to the market price of Reitz stock without having reasonable grounds to believe that a market existed for Reitz securities other than the market controlled by Midwest.

14. Defendant Midwest has violated § 15(c) of the Exchange Act and Rule 15c2-6 announced thereunder. It did so by selling Reitz securities without first making a reasonable suitability determination and approving the customer account for transactions in the security and without first getting a signed and dated customer suitability statement and purchase agreement from the customer.

15. Defendant Midwest has violated §15(g) of the Exchange Act and Rules 15g-3 through 15g-6 promulgated thereunder. It did so by effecting transactions in Reitz securities without sending monthly account statements to customers and without disclosing to customers that Midwest does not consistently execute trades at its quoted bid price, the price at which Midwest last bought Reitz Stock in bona fide inter-dealer transaction, the total compensation received by Midwest for transactions in Reitz stock, and the total compensation Midwest paid its salespeople for transactions in Reitz stock.

16. Defendants Eberle, Hodge, VanEcho, Williamson, Gilliland and Costello have aided and abetted Defendant Midwest's violations of §15(c) of the Exchange Act and Rule 15c2-6 promulgated thereunder. They did so by, with a general awareness that their roles were part of an overall improper activity, providing knowing and substantial assistance to Midwest's sales of Reitz securities without first approving the customer account for transactions in the security and without first getting a signed and dated customer suitability statement and purchase agreement from the customer.

17. Defendants Eberle, Hodge, VanEcho, Williamson, Gilliland and Costello have aided and abetted Defendant Midwest's violations of § 15(g) of the Exchange Act and Rules 15g-3 through 15g-6 promulgated thereunder. They did so by, with awareness that their roles were part of an overall improper activity, providing knowing and substantial assistance to Midwest's transactions in Reitz securities without sending monthly account statements to customers and without disclosing to .customers that Midwest does not consistently execute trades at its quoted bid price, the price at which Midwest last bought Reitz Stock in a bona fide inter-dealer transaction, the total compensation received by Midwest for transactions in Reitz stock, and the total compensation paid to Midwest's salespeople for transactions in Reitz stock.

18. Sections 20(b) of the Securities Act and 21(d) of the Exchange Act provide that" upon a proper showing a ...temporary injunction or restraining order shall be granted..." Injunctions based upon the federal securities laws protect the investing public from future misconduct. S.E.C. v. Youmans, 729 F.2d 413, 415 (6th Cir.), cert. denied, 469 U.S. 1034 (1984). For a court to issue a preliminary injunction, the plaintiff must show "a strong likelihood of success on the merits." Adams v. Federal Express Corp., 547 F.2d 319, 323 (6th Cir. 1976). The applicable standard of proof is a preponderance of the evidence. Herman & MacLean v. Huddleston, 459 U.S. 375, 390 (1983); Steadman v. Securities and

Exchange Commission, 450 U.S. 91, 101-02 (1981). In injunctive actions brought by the Commission, the Commission must show a likelihood of success on the merits, but does not need to show irreparable harm or the inadequacy of legal remedies. Youmans, 729 F.2d at 415. Rather, it must show only that there is a reasonable and substantial likelihood that the defendants, if not enjoined, would violate the federal securities laws in the future. Id. (citations omitted). The following factors are applicable in determining the likelihood of future violations:

1. the egregiousness of the violations,
2. the isolated or repeated nature of the violations,
3. the degree of scienter involved,
4. the sincerity of the defendant's assurances, if any, against future violations,
5. the defendant's recognition of the wrongful nature of his conduct,
6. the likelihood that the defendant's occupation will present op-

portunities (or lack thereof) for future violations, and

7. the defendant's age and health. Id.

First, the Defendants' conduct is egregious given the substantial participation of each in a fraud on the investing public. Defendants have engaged in manipulation the price of Reitz to arbitrarily high levels and charged customers prices that bear no relationship to the prevailing market prices. One example of the egregiousness of the violations is that Midwest charged undisclosed markups of 152% to 188%. Eberle and Hodge, with the assistance of Costello, Gilliland, VanEcho and Williamson, personally set these arbitrary prices. Costello, Gilliland, VanEcho and Williamson have enabled Midwest to control the supply of Reitz stock by selling stock and warrants to Midwest, using high pressure sales tactics to sell Reitz to the public, and selling Reitz stock to the public at prices which include excessive, undisclosed markups. Moreover, Eberle, Hodge, VanEcho, Costello, Gilliland and Williamson aided and abetted Midwest's violations of the Commission rules designed to protect investors,

The second factor to consider is the isolated or repeated nature of the violations. The Defendants have manipulated the price of Reitz in hundreds of transactions.

The third factor is Defendants' scienter. Defendants' conduct demonstrates a high degree of scienter.

The fourth and fifth factors also show the likelihood of future violations. Defendants have neither given assurances against future violations nor recognized the wrongful nature of their conduct,

With respect to the sixth factor, all of the Defendants work in the securities industry. They are all able to continue to carry out their scheme to defraud. It is, therefore, very likely that the Defendants will continue to sell shares of Reitz to the public at arbitrary prices and to violate the cold-calling and penny stock disclosure rules unless enjoined. With regard to the seventh factor, all of the Defendants are sufficiently young and in good enough health so that they may continue to violate the securities laws in the-future.

19. The Commission has shown by a preponderance of the evidence a reasonable and substantial likelihood that Defendants, if not enjoined, would Violate the securities laws in the future. Youmans, 729 F.2d at 415. The Commission has also shown a strong likelihood of success on the merits in this case. Id.

III. PRELIMINARY INJUNCTION ORDER

Based on the above:

1. The Court preliminarily enjoins Defendants and their agents from selling or offering for sale Reitz stock or any other securities in violation of any securities laws as described in the above Conclusions of Law.

2. The Court preliminarily enjoins Defendants and their agents from selling or offering for sale Reitz stock or any securities to the public without first obtaining written permission of the Court, and after providing the Commission twenty (20) days notice of all of the appropriate details of the proposed offer or sale.

3. The Court preliminarily enjoins Defendants and their agents, and any persons who receive actual notice of this Order, from transferring or disposing of any funds or assets of Midwest without first obtaining written permission of the Court, and after providing the Commission Seven (7) days notice of all of the appropriate details of the proposed transfer or disposal.

4. Defendants shall, within Seven (7) days after the date of this Order, provide the Commission with the materials requested on pages 14 and 15 of the Commission's Motion for Order of Preliminary injunction and Other Relief.

5. The Court preliminarily enjoins Defendants and their agents, and any persons who receive actual notice of this Order, from destroying, mutilating, altering, or concealing any books, records documents, computer data, correspondence, brochures, manuals, obligations, or other property of or pertaining to Defendant Midwest, wherever located.

IT IS SO ORDERED.

/s/ George C. Smith
GEORGE C. SMITH, JUDGE
UNITED STATES DISTRICT COURT

Date: May 18, 1993